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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
1998 Biennial Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers	)	CC Docket No. 98-137
	)	
Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit, *et al.*	)	CC Docket No. 99-117
	)	
GTE Telephone Operating Companies Release of Information Obtained During Joint Audit	)	AAD File No. 98-26

REPLY COMMENTS OF AT&T CORP.

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the *Further Notice* in the above captioned proceeding,[1] AT&T Corp. ("AT&T") hereby submits its reply comments concerning the Commission's proposal to codify, through depreciation prescription rule changes, proposals by certain price-cap incumbent local exchange carriers ("LECs") that they be granted waivers of those rules without the protections against adverse impacts on consumers and competition that the Commission recently ruled are necessary to justify such waivers.[2]

INTRODUCTION AND SUMMARY

There is universal agreement among consumer advocates, LEC customers, and state commissions that the dominant price-cap LECs' request for a blanket waiver of the

[1] *Further Notice of Proposed Rulemaking, 1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carries*, CC Docket Nos. 98-137, 99-117, AAD File No. 98-126 (April 3, 2000) ("Further Notice").

[2] *See* March 3, 2000 Letter from Robert T. Blau, Vice-President-Executive and Federal Regulatory Affairs, BellSouth, to Ms. Magalie Roman Salas, Secretary, Federal Communications Commission (*"March 3 LEC Letter"*).

Commission's depreciation prescription rules without the important safeguards that the Commission just endorsed does not serve the public interest and should be denied.[3] Adjustments by one-time, below-the-line write-downs of the dominant LECs' regulatory books, as endorsed in the *Depreciation Order,*[4] would have the support of all of the Commission's in-place and well-tested accounting safeguards to prevent any rate impacts. The dominant LECs have not shown that their proposal of a five-year *above-the-line* amortization – for which they offer no affirmative public interest rationale – would provide the same level of protection. As US WEST concedes, "[a]bove-the-line accounting creates a *presumption* that such expenses will be included in a carrier's revenue requirement for ratemaking purposes." US WEST at 7 n.21 (emphasis added). By definition, both the risk of improper rate impacts and the oversight burden on ratepayers, state agencies and the Commission would increase.

Lacking any public interest rationale for their proposal, the dominant LECs assert that it is nonetheless supported by Commission precedent and financial accounting principles. Not surprisingly, however, the LECs are unable to cite a single case where the Commission approved an amortized, above-the-line write-down of regulatory books by a *dominant* carrier. Indeed, the

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[3] *See* Comments of: MCI WorldCom ("MCIW"), Public Service Commission of Wisconsin ("PSCW"), Indiana Utility Regulatory Commission ("IURC"), General Services Administration ("GSA"), National Telephone Cooperative Association ("NTCA"), Ad Hoc Telecommunications Users Committee ("Ad Hoc"), International Communications Association and the Consumer Federation of America ("ICA/CFA"), National Exchange Carrier Association ("NECA"), National Rural Telecom Association and the Association for the Promotion and Advancement of Small Telecommunications Companies ("NRTA"), National Association of Regulatory Utilities Commissioners ("NARUC"), The Association For Local Telecommunications Services ("ALTS"), *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carries,* CC Docket Nos. 98-137, 99-117, AAD File No. 98-126 (filed April 17, 2000).

[4] *See* Report and Order, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers,* CC Docket Nos. 98-137 et al. (December 30, 1999) ("*Depreciation Order*").

primary case cited by the LECs explicitly held that such adjustments may be suitable for *financial* records, but are not appropriate for dominant carriers' *regulatory* records. The Commission has likewise expressly rejected the notion that a GAAP determination that a particular accounting treatment might offer sufficient protections for shareholders in the context of *financial* books means that the same approach would also offer sufficient safeguards for ratepayers in the context of *regulatory* books.

Finally, there is overwhelming agreement among consumer advocates, LEC customers, and state commissions that reconciling the dominant LECs' regulatory accounting books with their financial accounting books could not possibly moot resolution of, or further Commission proceedings on, the Commission auditors' findings that those LECs have included billions of dollars of missing central office equipment in their continuing property records ("CPR"). But, as AT&T and other have pointed out, prospective corrections, although certainly warranted, cannot cure the substantial past rate impacts of the LECs' CPR inflation. The CALLS plan also does not address other issues raised in the CPR audit proceeding, *e.g.*, whether the dominant LECs should be required to engage independent auditors to evaluate their record-keeping practices and to conduct full inventories.

ARGUMENT

I. THE BLANKET DEPRECIATION WAIVER SOUGHT BY THE INCUMBENT LECS WOULD NOT SERVE THE PUBLIC INTEREST AND IS CONTRARY TO COMMISSION PRECEDENT.

In the *Depreciation Order*, the Commission stressed that it would consider alternative waiver proposals only "if they are designed to achieve the same protections we seek to assure with the waiver mechanisms described herein." *Id.* n. 77. The comments confirm that the *March 3 LEC Letter* proposal does not remotely meet this standard. Above-the-line treatment creates a presumption that the expenses associated with a write-down *will* be included in the revenue requirement from which rates are determined. Indeed, U S WEST supports above-the-line treatment precisely because it would permit the LECs to recover the adjustment through rates.[5] SBC and Bell Atlantic likewise reveal their belief that the proposed depreciation write-offs belong in rates and that amortization of the proposed depreciation adjustments legitimizes historical costs in stating that the depreciation adjustment represents "actual costs, previously regulated by the Commission . . . [and] should be included for purposes of determining reported regulatory earnings, i.e. the amortization is an 'above the line' expense." Bell Atlantic at 2.[6]

Amortization over five years also greatly increases the complexity of determining whether rates have been impacted. As many commenters demonstrate, that would provide myriad opportunities – opportunities that would not exist under the *Depreciation Order* approach – for dominant LECs intentionally or unintentionally to harm consumers and competition. *See* Ad Hoc at 6-7 (listing ways that above-the-line write-offs amortized over five years would permit the incumbent LECs to recover those write-offs from ratepayers); PSCW at 3-4; MCIW at 6-8; ICA/CFA at 3; IURC at 4-5.

That explains why the incumbent LECs do not even attempt to explain how the public interest could be served by granting their waiver request rather than holding them to the

[5] *See* U S WEST at 8 ("if an amortization is allowed, it should be above-the-line and expenses and benefits associated with it should be reflected in all rate of return calculations that LECs are required to provide under price cap regulation"). *See also id.* at 7, n.21 (citing *Appalachian Electric Power v. FPC*, 218 F.2d 773, 777 (4th Cir. 1955).

[6] *See also* SBC at 5-6; GTE at 7, 10 (asserting that amortizing the depreciation expense above-the-line would correct for "uneconomically long life" ranges by "depress[ing] reported earnings compared to past years[,] . . . an inevitable by-product of moving" away from the Commission's prescribed life ranges); NARUC at 5 (explaining that an above-the-line amortization is inappropriate because, *inter alia,* "an above-the-line adjustment could infer that the carriers' financial depreciation rates are reasonable for regulatory purposes").

approach identified in the *Depreciation Order* or another approach that provides the same level of protection. There is simply no other reason (and the LECs certainly provide no other reason) for a dominant LEC to seek above-the-line treatment other than to enhance opportunities to, at some point and in some manner, pass the depreciation adjustments on to consumers through increased rates. *See, e.g.*, IURC at 5 ("[i]f the ILECs' are not going to seek recovery of the amortization expenses in their interstate rates, either through a low-end adjustment, an exogenous adjustment, or an above-cap filing, then there is no harm to the ILECs if they adjust the difference between their financial and regulatory books through a below-the-line write-off, since the effect is the same"). A "pledge" not to pass any depreciation adjustment on to ratepayers is grossly inadequate given the "fundamental inconsistency between the [dominant] LECs' insistence that any amortization expense be recorded 'above-the-line' and the[ir] 'commitment' not to seek recovery of the amortization expense." MCIW at 8. *See also Depreciation Order* ¶ 7 (requiring a promise *plus* a one-time, below-the-line adjustment); PSCW at 4 ("insulating rates from this depreciation change should be a requirement, not merely a promise").[7]

The LECs claim that the Commission could keep them from acting on their incentive to cheat by simply seeking to "obtain whatever . . . information is needed . . . to assure" that any request for a cost adjustment "would not recover any of the amortized expenses." GTE at 9. In confirming that their proposal would shift to ratepayers, state agencies, and the Commission the burden of obtaining information necessary to assess compliance with the pledge not to increase rates, the LECs underscore that their proposal does not provide the same level of protection as the *Depreciation Order* approach, which does not require an independent

[7] *See also* IURC at 4-5; Ad Hoc at 6-7.

assessment of every proposed cost adjustment.[8] The LECs' comments likewise confirm that they plan to provide the Commission and the public with less, not more, information if their proposal is accepted. *See id.* ("No reporting requirements or additional protections are needed"); SBC 13-16 (same); *March 3 LEC Letter* at 1-2 (proposing that dominant LECs be permitted to submit "information" about the depreciation practices only when undefined "significant changes" are made).[9]

In the end, the only argument the dominant LECs can muster is their assertion that the accounting treatment they propose is not unprecedented. *See, e.g.*, SBC at 7; GTE at 8; BellSouth at 8. That is hardly a substitute for the required showing that the proposal would serve the public interest. In any event, the assertion is false. The dominant LECs cite a case that involved only proposed adjustments to *financial* accounting books. In that context, the Commission found that:

> [a]s to the effect of the write-down of its assets, we note that AT&T's asset value and depreciation expenses are determined *separately for financial reporting and regulatory purposes.* Any write down by AT&T for financial reporting purposes has no effect on regulated investment amounts or prescribed depreciation expenses.

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[8] The LECs insistence that no promise is needed (or permissible) with respect to intrastate costs because the Commission has no authority over intrastate rates that recover those costs, *see, e.g.*, U S WEST at 5-7; Bell Atlantic at 3-5; SBC at 10, misses the point. Above-the-line adjustments amortized over five years are inappropriate because they would make it easier for the LECs to conceal improper rate increases – particularly given the allocation of costs and rate-making authority among jurisdictions. The Commission is certainly free to consider any implications proposed changes to its accounting rules would have on the ability of state regulators' to exercise oversight over intrastate rates.

[9] In addition, as recognized by several of the comments, the depreciation and related information submitted by LECs is relied upon "by the federal and state regulatory commissions for determining the appropriate depreciation factors to use in establishing high cost support, interconnection and unbundled network element prices." GSA at 8 (citing *Further Notice* ¶ 8); *see also* Ad Hoc at 8-9; NRTA at 4; IURC at 4. Thus, the dominant LECs' proposal to limit this information to that which they deem to be "significant" is entirely unacceptable. *Id.*

Order, *The Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, As Amended for AT&T Corp.*, 4 FCC Rcd. 1466, 1468 ¶ 16 (January 1989) (emphasis added). And the Commission has consistently rejected requests by dominant carriers to adjust their *regulatory* accounting books through above-the-line adjustments. Thus, in 1989, when AT&T (then classified as a dominant carrier) sought to adjust its regulatory books in order to reconcile them with its financial books, the Commission unconditionally rejected AT&T's request. *See* Memorandum Opinion and Order, *The Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T and the Prescription of Revised AT&T Depreciation Rates,* 4 FCC Rcd. 8567, 8570 ¶ 23 (1989) ("We conclude that AT&T has not made a sufficient showing that this Commission should base AT&T's book rates on the depreciation rates it uses for financial reporting purposes").[10] AT&T was refused this relief even though it was subject to substantial competition and had only a 67.5 percent market share.[11] The dominant LECs' shares continue to exceed 90 percent. *See id.* Indeed, the Commission did not provide AT&T with the type of relief sought by the incumbent LECs until AT&T was declared a *non-dominant* carrier in 1995. *Id.* Furthermore, the Commission only granted AT&T such relief upon AT&T's demonstration that it was actually retiring its plant at a rate consistent with its requested depreciation relief. The LECs have made

[10] *See also* Public Notice, *Depreciation Rate Prescriptions Proposed for the American Telephone and Telegraph Company*, 5 FCC Rcd. 15 (1989) ("The Commission declined to change its procedures to allow AT&T to file book depreciation rates that are based on the data and methodologies AT&T uses for financial reporting purposes"); Order, *The Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, for American Telephone and Telegraph Company*, 5 FCC Rcd. 660, ¶ 2 (1990) ("the Commission declined to change its procedures to allow AT&T to base its book depreciation rates on the data and methodologies AT&T uses for financial reporting purposes").

[11] *See* MCIW at 12-13 (citing Industry Analysis Division, *Long Distance Market Shares*, June 1998, Table 3.2).

no such showing here, and indeed they could not. Over the past several years, the major price cap LECs consistently have been retiring about $10 billion *less* in plant each year than their regulatory depreciation charges.

Finally, the dominant LECs' wrongly assert that they should be permitted to take above-the-line write-offs amortized over five years in their regulatory books because such an adjustment might be consistent with financial accounting practices like GAAP. This argument ignores the simple fact that financial accounting practices, including GAAP, are designed to ensure that certain *financial* accounting procedures are in the best interest of *shareholders* – they are not designed to ensure that *regulatory* accounting procedures protect *consumers* and the *public interest*. The Commission has recognized as much:

> The LECs' argument that external controls are sufficient is . . . unpersuasive. . . . One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results . . . which would mislead current and potential *investors*. GAAP is guided by the conservatism . . . [and] [a]lthough conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC to avoid its sharing obligation. [Thus,] GAAP does not offer adequate protection for ratepayers.

Report and Order, *Simplification of the Depreciation Prescription Process,* 8 FCC Rcd. 8025, 8044 ¶ 46 (Sept. 1993). Thus, financial accounting practices, such as GAAP, provide no support for the dominant incumbent LECs' claims that they should be permitted to take an above-the-line write-off that is strung out over five years rather than a single below-the-line adjustment.[12]

[12] As explained above, the rural LECs' objection to the current waiver proposal is well-taken. The rural LECs' have not, however, demonstrated that there is merit to their broader suggestion that *any* reconciliation of financial and regulatory depreciation could result in "unintended reductions in the universal service support for rural telephone companies." NRTA at 3. In particular, because universal service is currently and appropriately capped at levels below the levels for which rural carriers would otherwise qualify, it is far from clear that any increases in the national average loop cost occasioned by depreciation adjustments for the price cap LECs

Indeed, if this plant was really valueless, traditional financial accounting practices would generally require an immediate, one-time adjustment – not one spread out over five years.

II. NEITHER THE 5-YEAR AMORTIZATION CONTEMPLATED BY THE LECS' WAIVER PROPOSAL NOR ANY OTHER PROSPECTIVE WRITE-OFF COULD WARRANT TERMINATION OF THE CPR AUDIT PROCEEDINGS.

The overwhelming majority of the comments confirm that the current proceedings are unrelated to the CPR proceedings and that neither the five-year amortization contemplated by the LECs' waiver proposal, nor any other prospective write-off could warrant termination of the CPR audit proceedings.[13] *See, e.g.*, PSCW at 5-6 ("[t]he Wisconsin Commission does not believe that the two matters are related").[14] In the CPR proceedings,[15] the Commission's staff found that, combined, Regional Bell Operating Companies ("RBOCs") "could not account for approximately $5 *billion* of central office equipment." *Further Notice* ¶ 15 (emphasis added). As AT&T and others have demonstrated, and as several comments in this proceeding confirm, overstatement of CPR has produced overstatement of rates, even under the Commission's current incentive approach.[16]

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would translate into reductions in the universal service support actually received by rural telephone companies.

[13] Indeed, the issues in these two proceedings are entirely disconnected. Adjustments to depreciation reserves (the issue at hand) are completely different than adjustments to gross plant (the issue in the CPR proceedings). *See, e.g.*, MCIW at 21 ("The write-offs proposed in the Notice would affect the ILECs' depreciation reserve, whereas the write-offs recommended by the auditors would primarily affect their gross plant"); GSA at 9 (same).

[14] *See also* MCIW at 21; Ad Hoc at 9-10; ICA/CFA at 5-6; IURC at 6; GSA at 9-10.

[15] *See* In the Matter of Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit, et al., Docket No. 117.

[16] *See* MCIW at 21-22; PSCW at 5-6; GSA at 9-11; 10-12. *See also* Comments of AT&T, CC Docket No. 99-117 at 30-33 (filed September 23, 1999); Reply Comments of AT&T, CC Docket No. 99-117 at 36-37 (filed October 15, 1999).

Several RBOCs nonetheless assert that adoption of the CALLS plan would moot the CPR audit proceedings.[17] They argue that "[b]y increasing the regulatory depreciation reserve balance to match the depreciation reserve on the financial books, [non-complying RBOCs] . . . will reduce [their] net regulatory investment significantly more than the retirement of the assets identified in [the Commission's] CPR audit." BellSouth at 13. Thus, the RBOCs conclude, "[w]ith prospective rates set by the CALLS Plan, there can no longer be any doubt that prices are completely independent of investment levels reflected in BellSouth's permanent records of engineering equipment [and, therefore] it is pointless to continue the debate concerning the accuracy of those records." *Id.* at 13-14.

Although an immediate prospective write-down is surely warranted and could remove the impact of CPR overstatement on future rates, neither a write-down nor the proposed amortization would remedy the serious rate overcharges incurred in the past years as a result of the CPR overstatement. Indeed, the Commission's audits only examined the CPR of hard-wired central office equipment – equipment which is both less likely to be missing than other equipment and which only represents a small fraction of total LEC plant. Consequently, it is impossible to conclude that a $28 billion write-off would compensate for the total amount of plant that might be missing. Any attempt by the dominant incumbent LECs to equate this amount to the Commission's discovery of a $5 billion deficiency in hard-wired central office equipment alone is specious. *See, e.g.,* Bell Atlantic at 7; BellSouth at 13; GTE at 14.

Moreover, the recommendations in the CPR audit go well beyond the issues before the Commission in this proceeding. *See, e.g.,* IURC at 6. For example, the Commission staff recommended that several RBOCs: 1) engage an independent firm to conduct a complete

[17] *See* BellSouth at 12-14; GTE at 14-15; U S WEST at 9-10; SBC at 16; Bell Atlantic at 6-8.

inventory of its central office equipment; and 2) engage an independent auditor to evaluate the practices, procedures and controls that the RBOCs have in place to maintain their CPRs, and to recommend improvements to ensure reliability and accurate account balances and records.[18] Nothing in the CALLS Plan addresses these issues.

The issues in this proceeding and the CPR proceeding are entirely disconnected. Adjustments to depreciation reserves (the issue at hand) are completely different than adjustments to gross plant (the issue in the CPR proceedings). Indeed as noted by MCI (at 21) "[t]he write-offs proposed in the notice would affect [only] the ILECs' depreciation reserve, whereas the write-offs recommended by the auditors would primarily affect their gross plant." *See also* GSA at 9. Even the CALLS LECs recognize this difference. *See, e.g.,* SBC at 5 (asserting that in this proceeding "the *depreciation reserve*" should be adjusted) (emphasis added); GTE at 2 (arguing that *"depreciation reserves"* should be adjusted) (emphasis added). Thus, regardless of what the Commission does in this proceeding and regardless what steps the RBOCs take in the future to remedy their CPR overstatements, there is no substantial reasoned basis to terminate the CPR audit proceedings.

[18] *See, e.g.,* IURC at 6 (citing Audit of the Continuing Property Records of Ameritech Corporation as of July 31, 1997, FCC Accounting Safeguards Division, December 22, 1998).

CONCLUSION

For the foregoing reasons, the Commission should deny the incumbent price-cap LECs' waiver proposal.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I, Peter Andros, do hereby certify that on this 28th day of April, 2000, a copy of the foregoing Reply Comments of AT&T Corp. was served via U.S. first class mail, postage prepaid, to the parties listed on the attached Service List.

/s/ Peter Andros
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